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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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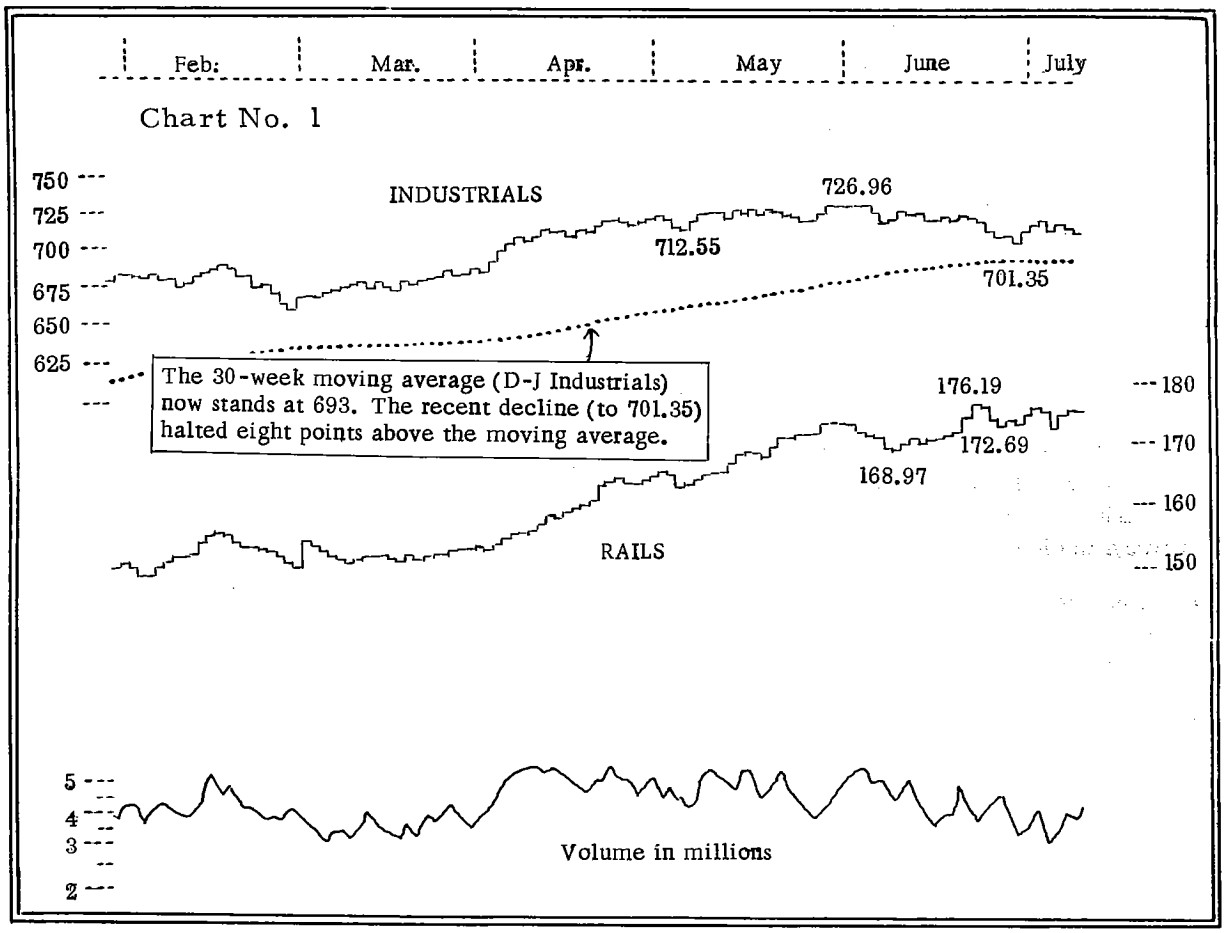
THE MARKET (Opening comments): The technical deterioration from the standpoint of the larger picture has been discussed in recent Letters. The "summer rally" idea has now become an obsession with most analysts. That there will be a summer rally, I don't doubt for a moment. Even in the "dog" years of 1930 and 1931 there were summer rallies as the records of July-August, 1930 and May-June,1931, will show. The fact that these rallies were sandwiched in between successive "crashes", is of course, now forgotten. The point is that it is not necessarily the summer rally which is important -- what is important is the level from which the summer rally takes place.

The following discussion makes the case for a summer rally beginning from above the 701.35 (Industrial) and 168.97 (Rail) level. From a trading standpoint, positions could be assumed on the next decline with the stipulation that they be "cleaned out" if both of those levels (i.e., 701.35 and 168.97) are violated.

Attention was directed in the last two Letters to the long, sideways movement in the Industrial Average, a movement which between April 23 and June 25 held Industrials within a narrow range of 2%. On June 26 the forty-five day trading range was broken on the downside. But as noted in the last Letter (No. 223): "...the Industrial violation of the 712.55 level cannot be considered a definite sign of weakness unless confirmed by a comparable decline in the Rail Average (below 168.97). A persistent refusal by Rails to violate 168.97, in fact, could lead to a good recovery."

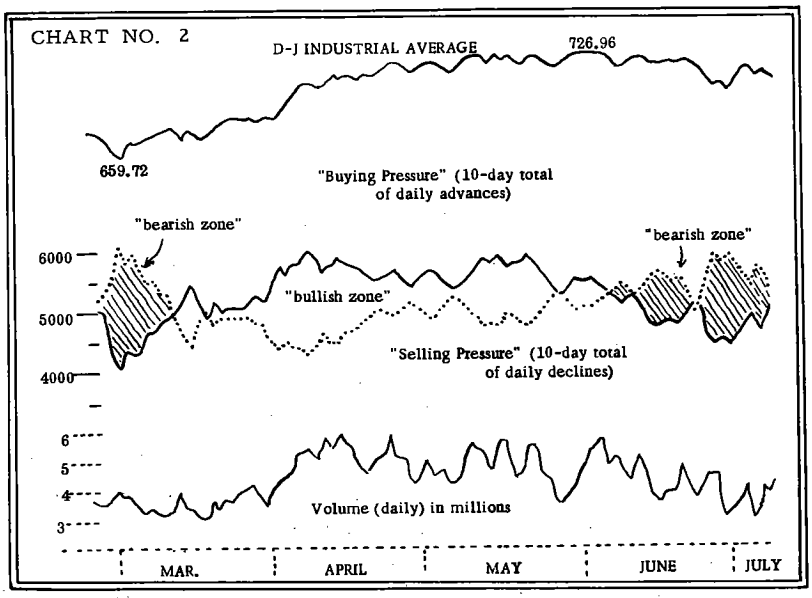
What occurred following the Industrial penetration was most interesting. On July 1, Industrials recorded a decline low of 701.35 (see chart #1). This low, however, was not confirmed by a comparable penetration of Rails below 168.97 (Rails stopped at 172.69). A rally ensued, followed by a second decline in which Rails (on strike news) broke below their immediate preceding low of 172.69 -- but here it was the Industrials which refused to confirm the Rail weakness. On this second decline, Industrials held firmly above their July 1 low of 701.35.

Thus from the standpoint of Industrials, all the action took place from above their 30-week moving average (see chart), and the fact that this long-term line has not yet been penetrated should be considered a technical plus. From the Rail standpoint, all the action took place from above the 168.97 level, and this too can be considered a plus. The net result of the price movement since July 1 amounts to a double non-confirmation on the downside, and this could set the base for a "summer rally".



In other words, as long as one or both Averages hold above the 701.35 (Industrial) and 168.97 (Rail) levels, the secondary trend may be taken to remain bullish. What would reverse the plus implications? Obviously, joint penetration of the 701.35 and 168.97 levels on increasing volume would put the market in a decidedly bearish light. If both of those levels are violated, selling will undoubtedly prove the better part of valor.

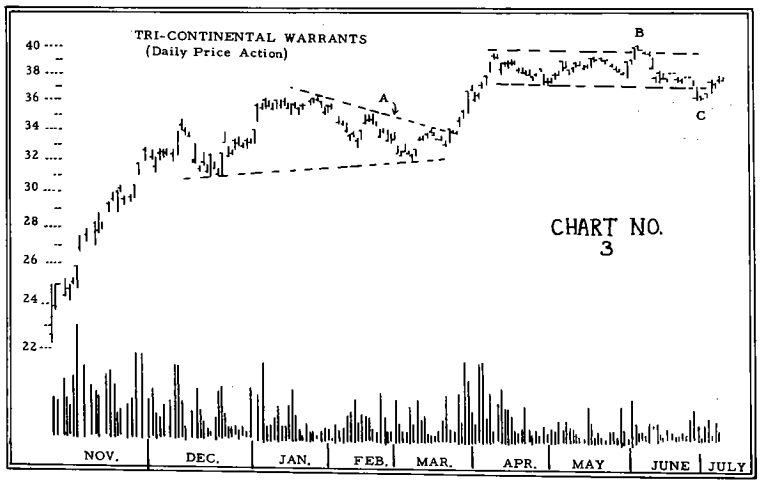
BUYING AND SELLING PRESSURE: The selling pressure line rose above the buying line on June 6. It has held the dominant position ever since. This means that selling has been above buying for a period of 24 trading days, the longest such period since September-October, 1962. The length of time is the negative aspect, but the hopeful side is that volume (see chart No. 2) has tended to decrease as the lines assumed a bearish position.



As long as selling holds above buying, this study is saying "caution". A further spread between the two lines with accompanying high volume would spell "danger" while a recrossing (with buying above selling) would obviously mean that the danger is past.

SPECULATIVE BAROMETER In Letter 214 I presented a study of a "key" speculative stock -- the Tri-Continental warrant. The TY warrants are perpetual (i.e., no expiration date), and each warrant is convertible at any time into 1.27 shares of Tri-Continental common at a price of $17.67. This means that the warrant constitutes a "call" on the largest closed-end fund in the nation. The Tri-Continental Corporation, in fact, is so large that it tends to act like a breadth of the market indicator, and at times the movements of TY common and its sensitive warrants may be more significant (as far as the market trend is concerned) than the action of the Industrial Average itself. The TY warrants almost always harbor a large short position, they are well leveraged, they have a professional following, and for these reasons they tend to anticipate (or at times confirm) the movements of the Industrial Average.

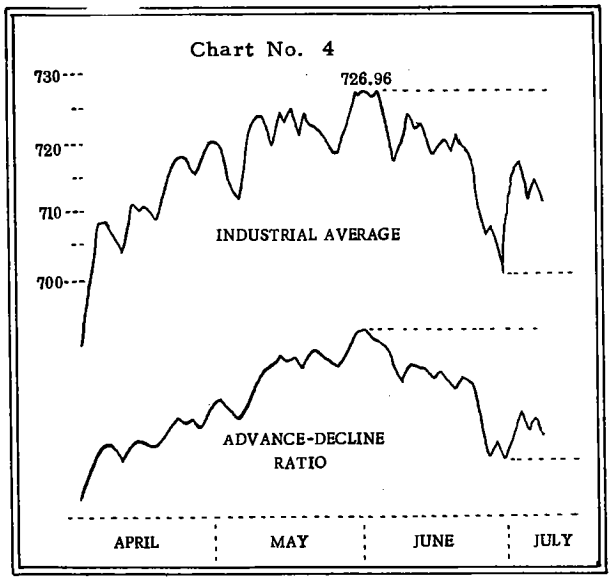
With the above discussion in mind, it is interesting to follow the path of the warrants over the past few months. From November, 1962, through March, 1963 (see chart No. 3) the warrants formed a "toppy" appearing pattern, a formation which seemed to be a sort of "head-and-shoulders" affair. But when the warrants broke above trendline A (on chart) they moved above their January peak of 36 1/2 to a high of 39 3/4 in April. This represented only a slight advance above the January high, and although the Industrial Average and the advance-decline ratio continued to rise until May 31, the warrants refused to go higher. Finally, at the end of May (B on chart) the Warrants broke above the 39 3/4 high, but they immediately reversed trend and headed down. This was a warning, and experience has taught this writer that a "false move" on the warrants is always worth watching.



It was now apparent that the warrants had formed a rectangle (a rectangle is actually a "line" in an individual stock). The limits of the rectangle were 40 1/4 and 37 1/2. On the last day of June (C on chart) the warrants violated the lower limits of the rectangle -- thus going into a definite downtrend.

As the situation now stands, the warrants have a heavy "supply" above them in the form of the violated rectangle, and this is not an encouraging omen either for the warrants or the market. In order to turn bullish, the warrant will have to "plow" through the rectangle, then above point B again to a new high. Thus a price of approximately 42 would be needed to label the warrants bullish again.

THE "BLUE CHIPS" AND THE MAJORITY: Primary movements in the market tend to discount important (forthcoming) trends in corporate profits. Historically, it can also be shown that fundamental (or primary) swings in the economy affect the fortunes of the great majority of corporations -- not just a few groups or a handful of blue-chip equities. In other words, in a true expanding economy, almost all corporations are favorably influenced to at least some degree, and almost all stocks therefore tend to rise together.



The Industrial Average is representative of thirty of the biggest, richest and best run corporations in the nation. These thirty stocks tend to ourperform the general market when the "going gets rough". Moreover, because the D-J Industrial stocks are such superior companies, they tend to be the last stocks to turn down when the primary trend reverses from bull to bear.

This leads to the technical phenomenon which has so often been described in these Letters, the classic danger signal consisting of a series of new highs in the Industrial Average offset by a series of successively lower peaks in the advance-decline ratio (as subscribers know, the A-D ratio is representative of the advancing or declining tendencies of the majority of stocks on the N.Y.S.E.). In other words, this divergence between the Industrial Average and the A-D ratio is the technical counterpart of a situation wherein the majority of American corporations are unable to confirm the improving fortunes of a group of thirty leading blue-chip companies.

Whenever the Industrial Average and the A-D ratio undergo a significant decline, the situation becomes interesting because the question then arises: will the two indicators be able to rally above the preceding highs and thereby reconfirm the upward trend? Or will the Industrial Average alone rise to recovery highs, thus leaving the door open for a series of ascending peaks in Industrials and declining peaks in the A-D ratio? Such divergence on the part of the two indicators has often in the past been the harbinger of serious trouble ahead.

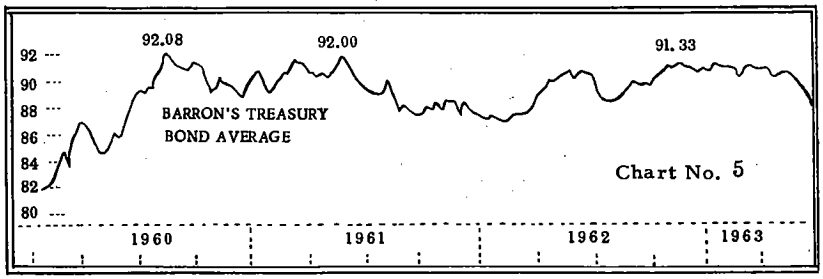
The important questions now is -- can the rally which began on July 2 succeed in taking both the Industrial Average and the A-D ratio above their preceding highs? Chart No. 5 depicts the path of these two indicators since April. So far, the A-D ratio has lagged somewhat behind the Industrial Average on the recovery. But it is too early to tell whether bullish joint highs, a bearish non-confirmation or a series of downward zig-zags is to be the market's fate.

MORE ON MONEY Judging from letters which arrive here almost daily, one of the biggest current "weights" on the minds' of sophisticated investors is the subject of money. "What happens if devaluation occurs?" I am asked. "What if interest rates go higher?" "Can we have inflation and tight money?" Everyone has excellent questions; few have intelligent answers.

My own guess is that devaluation will not come except as a possible last resort. It seems to me that devaluation might be used by the Administration during the depth of a crisis -- after all else had failed.

The ramifications of devaluation are many. For instance, foreigners now own huge amounts of U.S. properties, stocks, land, businesses, etc. These "things" are worth varying amounts of dollars. If foreigners decide to sell these properties, they will then receive dollars for their goods. These dollars could then be exchanged for U. S. gold on request. But suppose the price of gold was raised (i.e., devaluation)? This would mean that all foreign holdings in the U. S. would be worth considerably less in terms of gold. In effect, devaluation would be tantamount to "stealing" huge chunks of value from the properties of foreigners (in terms of their own money). The implications of devaluation from this one viewpoint are obvious -- if foreigners suspected devaluation was coming they would "dump" stocks and properties on the U. S. market in an effort to get (1) into cash, (2) then into gold, (3) and finally to exchange gold into their own more trustworthy currencies.

Meanwhile, our administration complains that foreigners continue to borrow in our money markets, thus piling up even bigger balances of U. S. dollars. But why shouldn't they borrow here? Our interest rates have been kept at artifically low levels for years.



Lately, however, the money market has begun to stir again, and the drama is heightening. In Letter 221 (June 12) I enclosed a chart showing the path of Barron Treasury Bond Index. Attention was drawn to the fact that this index was heading down (meaning, of course, higher bond yields). The chart is updated with this

Letter (Chart No. 5), and readers can readily see the sharp downward sweep of Treasury Bond prices.

Last week Secretary Dillon promised a new "action program" to safeguard our soggy dollars. One obvious rumor is that the discount rate will be raised from its current 3% level. A second rumor which has reached this writer is that the U. S. balance of payments were "horrendous" during the second quarter, and that this prompted Mr. Dillon to come out and promise to do something. A final "grapevine" hint is that President Kennedy got an "earful" in Europe regarding our "do nothing" policy on balance-of-payments and has now decided to take the whole thing seriously.

At any rate, the money market is "talking", and last week I counted 16 of the 35 listed U. S. Treasury Bonds at yields of 4% or better (the complete listing with yields appears daily in the Wall Street Journal). This is significant. It is an unmistakable sign of tightening money.

While the timing is always obscure, it should not be forgotten that equity yields are constantly competing with fixed debt yields. "Big money " tends to seek safety first, yield second, and increment of capital last. With the D-J Industrials yielding 3.3%, Treasury Bills yielding 3.24%, banks yielding 3.5 to 4.0%, long-term Treasury Bonds yielding 4.0% or better in some cases, savings and loan associations yielding 4.85 to 5.0%, the battle for the return on one's dollar is intensifying. It could be the biggest picture facing the stock market over the foreseeable future.

STOCKS Of the 444 stocks which we tabulate at this office each week, 316 are now holding above their 30-week moving average. This represents 70% bullish or no change from the week before.

The last time I wrote about the golds was on June 3 (Letter 220). At that time I called attention to the fact that the golds were moving sideways and were attracting little attention. I added, however, that on a long-term basis their relative strength performance was slowly improving (i.e., relative strength against the general market). Slowly improving relative strength usually means an eventual important move on the upside.

The daily chart of Campbell Red Lake (below) shows an inverted "head-and shoulders" formation and a breakout with fairly good volume. This stock is rated bullish (and well worth having in every portfolio). I also include four small weekly charts of four leading gold stocks. All of these issues are now above their 200-day moving averages (fine dotted lines on charts) and all are rated bullish. This writer continues to recommend the inclusion of golds in all portfolios.

From the standpoint of relative strength, the two strongest groups are now Rails and Oils. In the latter Standard of Jersey and Texaco are outstanding and should make good trading commitments for a rally. In the carrier group, I continue to like the stocks mentioned last week, Pennsylvania, N.Y. Central, Illinois Central, Southern Pacific.

(Large chart of Campbell Courtesy of Traders Research, P.O. Box 2466, St. Louis 16, Missouri. Small chart courtesy of Quote Digest, 110, North Lorraine, Wichita, Kansas).